REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

DEFAULTED LOANS UNDER THE CALIFORNIA GUARANTEED STUDENT LOAN PROGRAM

P-380

SEPTEMBER 1984

REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

P-380

DEFAULTED LOANS UNDER THE CALIFORNIA GUARANTEED STUDENT LOAN PROGRAM

SEPTEMBER 1984

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September 20, 1984

P-380

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the cumulative default rate of the California Guaranteed Student Loan Program (CGSLP) and the dollar effect of defaults on the State Guaranteed Loan Reserve Fund. Since federal fiscal year 1981-82, the CGSLP's cumulative default rate has been increasing. This rise in defaulted loans, as expressed by the cumulative default rate, increases the burden to federal taxpayers because the federal government purchases most of these defaulted loans.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

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SUMMARY

The Student Aid Commission's (commission) California Guaranteed Student Loan Program (CGSLP), which began in April 1979, makes low-interest loans available to students to pay for the costs of attending postsecondary schools. The federal government generally considers a loan under the CGSLP to be in default if a student fails to make a required payment on the loan within 120 days of the date that the payment is due. Two commonly used but unrelated ways of discussing defaults are the "cumulative" (or "cumulative gross") default rate and the "trigger reinsurance" rate. The rise in the dollar amount of defaulted student loans, as expressed by the cumulative default rate, increases the burden to federal taxpayers because the federal government must ultimately purchase a majority of the defaulted loans.

The Cumulative Default Rate

The cumulative default rate, which is used as a general indicator of the dollar amount of loans that have defaulted over the life of the CGSLP, has risen each year since the inception of the CGSLP. Because the CGSLP is a relatively new program, 1981-82 was the first year in which a significant number of students began to repay loans. The cumulative default rate rose to 6 percent at the end of federal fiscal year 1981-82, compared to a cumulative default rate of 1.8 percent in the previous federal fiscal year. By the end of the 1982-83 federal fiscal year, the cumulative default rate had increased to nearly 9.5 percent. As of June 30, 1984, the cumulative default rate for the CGSLP was 13.1 percent; of the $946 million in matured loans, $124 million were in default.

Specific cumulative default rates can be determined for each educational segment of the CGSLP. For example, as of June 30, 1984, cumulative default rates ranged from 5.0 percent for hospital education

programs and 6.1 percent for the University of California to 26.7 percent for private vocational schools. Although students with CGSLP loans who attend vocational schools account for only 17.3 percent of the CGSLP's matured loans, these students account for 35.3 percent of the total dollar amount of defaulted loans. In contrast, students with CGSLP loans who attend hospital education programs and those who attend the University of California together account for 12.7 percent of the matured loans but only 6.0 percent of the total dollar amount of defaulted loans under the CGSLP.

The Trigger Reinsurance Rate

The trigger reinsurance rate, which is defined by federal regulations, determines the percentage of the dollar amount of defaulted loans that the federal government will pay and the percentage that the commission must pay during a federal fiscal year. The higher the trigger reinsurance rate, the more the commission must pay for defaulted loans.

Beginning October 1, 1983, the commission became liable for a percentage of the unpaid balance on defaulted loans. In March 1984, the CGSLP's trigger reinsurance rate exceeded limits specified by the federal government, and the commission became responsible for paying at least 10 percent of the dollar amount of defaulted loans until the end of the federal fiscal year. As a result, for all defaulted loans purchased as of May 31, 1984, the commission had paid approximately $1.7 million, while the federal government had paid approximately $47 million.

The commission used money from the State Guaranteed Loan Reserve Fund (reserve fund) to pay for its portion of defaulted loans. The reserve fund receives no support from the State's General Fund; it is composed of federal funds, investment earnings, and insurance premiums paid by students. The balance of that portion of the reserve

fund that the commission specifically designates for the purchase of defaulted loans was approximately $43 million as of June 30, 1984. This amount does not include an additional $9.1 million in federal advances that could also be used to purchase defaulted loans.

The commission projects that the trigger rate for the 1984-85 federal fiscal year will again exceed specified limits in the fourth quarter, and the commission anticipates paying $2.8 million toward the purchase of defaulted loans. Nevertheless, the commission projects that the reserve fund will still increase by $7.3 million during federal fiscal year 1984-85 because of investment earnings and insurance premiums students will pay.

INTRODUCTION

The California Guaranteed Student Loan Program (CGSLP), which began in April 1979, makes low-interest loans available to students to pay for the costs of attending postsecondary schools. As of June 30, 1984, approximately $2.5 billion in loans had been guaranteed through the CGSLP.

These loans are made to students by banks, savings and loan associations, and credit unions. The Student Aid Commission (commission) guarantees the loans, thereby assuring the lender full payment should the loans become uncollectible because of death, disability, bankruptcy, or default. The federal government reinsures the loans and reimburses the commission for part or all of the insurance claims that the commission pays to lenders for uncollectible loans. The federal government pays the interest on loans while students are in school and during a "grace period" afterward. The federal government also pays an additional special allowance to lenders to enable them to make these loans at a low interest rate.

The commission provides overall administration for the CGSLP, while the Electronic Data Systems Corporation, a firm under contract with the commission, provides the day-to-day operations such as processing student loan applications and maintaining a data base that tracks the status of loans. Additionally, as the fiscal agent for the commission, the Electronic Data Systems Corporation purchases insurance claims from lenders and attempts to collect on defaulted loans.

The State's General Fund does not support the CGSLP. Funding is derived from administrative cost allowances that the federal government provides and from insurance premiums that students pay. This insurance premium, which the commission establishes, equals one percent of the principal amount of the loan for each year that the student is in school plus one additional year. The commission uses the insurance premiums to help pay for defaulted loans. In addition to the insurance premiums, students must pay an origination fee for each loan; the federal government has set this fee at 5 percent of the principal amount of the loan. Fees collected are used to offset a portion of the interest that the federal government pays to the lenders.

Undergraduate and vocational school students may borrow up to $2,500 each school year, to a maximum of $12,500 for undergraduate studies. Graduate or professional school students may borrow up to $5,000 each school year, to a maximum of $25,000 including undergraduate loans. The current interest rate on new loans is 8 percent. Students who have outstanding loans at either 7 or 9 percent continue paying at those interest rates.

Once students graduate, leave school, or attend school less than half-time, they must begin to repay their loans. The repayment period begins after a six-month "grace period" for loans having an 8 or 9 percent interest rate and a nine-month grace period for loans having a 7 percent interest rate. Students must make regular monthly payments on the loan principal and interest. Failure to make a payment within

120 days after it is due is generally considered a default. The lender must attempt to collect the loan before the commission will purchase the defaulted loan from the lender. Once the loan is considered a default, the commission pays the lender the balance owed on the loan and the accrued interest; the federal government reimburses the commission for all or a part of this amount. Acting on behalf of the commission, the Electronic Data Systems Corporation then attempts to collect the debt from the student. The commission generally remits collections to the federal government for deposit in the Student Loan Insurance Fund; however, the commission is allowed to keep up to 30 percent of the amount to cover collection costs.

Two commonly used but unrelated ways of discussing defaults are the "cumulative" (or "cumulative gross") default rate and the "trigger reinsurance" rate. The cumulative default rate indicates the percentage of the cumulative dollar amount of defaulted loans compared to the cumulative dollar amount of matured loans. In contrast, the trigger reinsurance rate is used to determine the percentage of the dollar amount of defaulted loans that the federal government will pay and the amount that the commission must pay in a given federal fiscal year. The federal fiscal year runs from October 1 to September 30.

Any money that the commission must pay for the purchase of defaulted loans comes from the State Guaranteed Loan Reserve Fund (reserve fund). Funds for the CGSLP and the California Loans To Assist Students Program, a second loan program administered by the

commission, are included in the reserve fund. The California Loans To Assist Students Program began in fiscal year 1982-83; it accounted for only about $27,000 of the $21.2 million in reserve fund revenues and $1,460 of the $6.9 million in reserve fund expenditures during that year. In calculating the trigger reinsurance rate, the federal government includes defaulted loans and loans in repayment under both the CGSLP and the California Loans To Assist Students. However, the amounts attributable to the California Loans To Assist Students Program are minimal. For example, as of May 31, 1984, this program had accounted for approximately $198,000 of the $47 million in total defaulted loans for the 1983-84 federal fiscal year, and as of September 30, 1983, it had accounted for $10.9 million of the $640.9 million in loans in repayment.

The California Administrative Code requires that the commission deposit at least 80 percent of the insurance premiums collected for the CGSLP and the California Loans To Assist Students Program in the reserve fund specifically for the purchase of defaulted loans. The commission uses the remaining insurance premiums for the administrative costs of these programs.

SCOPE AND METHODOLOGY

This analysis provides information on the cumulative default rate of the CGSLP and the trigger reinsurance rate of the CGSLP and the California Loans To Assist Students Program. We reviewed the formulas

used to compute these rates to verify that the Student Aid Commission's calculations were correct. We also tested the student loan data at the Electronic Data Systems Corporation to determine the accuracy and reliability of the data. In addition, we reviewed the pertinent federal and state laws and regulations, the program accounting records for the State Guaranteed Student Loan Reserve Fund, and the commission's projections of the trigger reinsurance rate. Finally, we interviewed staff at the U.S. Department of Education, the commission, and the Electronic Data Systems Corporation.

Our review of the Electronic Data Systems Corporation's computer file for the CGSLP involved two steps. First, we reviewed the computer program to verify that the system accurately accumulated the dollar amount of loans in the CGSLP. Second, we reviewed loan data for a random sample of borrowers in the CGSLP to determine if the data were correct. Based on these tests, we conclude that the commission's statistics on defaults that we have included in our report are reliable, although in some cases the statistics may be slightly overstated.

ANALYSIS

I

THE CUMULATIVE DEFAULT RATE OF THE CALIFORNIA GUARANTEED STUDENT LOAN PROGRAM

Because the Student Aid Commission's (commission) California Guaranteed Student Loan Program (CGSLP) is a relatively new program, a significant number of students did not begin to repay guaranteed student loans until federal fiscal year 1981-82. For federal fiscal year 1981-82, the "cumulative" default rate rose to 6 percent, compared to a cumulative default rate of 1.8 percent for federal fiscal year 1980-81. In federal fiscal year 1982-83, the cumulative default rate increased to 9.5 percent, and as of June 30, 1984, the cumulative default rate for the CGSLP was 13.1 percent. This rise in the dollar amount of defaulted loans, as expressed by the cumulative default rate, increases the burden on the federal taxpayer because the federal government must ultimately purchase most of these defaulted student loans.

The cumulative default rate is a general indicator of the dollar amount of loans that have defaulted over the life of the CGSLP. This rate is calculated by dividing the cumulative dollar amount of defaulted loans by the cumulative dollar amount of matured loans. Matured loans include loans in repayment or deferment, loans paid in full, and loans that cannot be collected because of death, disability, bankruptcy, or default. The cumulative default rate does not adjust

loans after they have gone into default. From January 1983 through April 1984, the commission had collected about $5.7 million on defaulted loans; however, about $2.0 million was used to pay for the costs of these collections.

The commission points out that there is a rate, the "net default rate," that reflects collections made after a loan has gone into default. The net default rate is calculated by dividing the dollar amount of loans currently in default by the cumulative dollar amount of matured loans. However, according to officials in the Guaranteed Student Loan Branch of the U.S. Department of Education, the net default rate may not be meaningful, and federal officials are currently reassessing the method of calculating the net default rate. One problem with the net default rate is that it may understate the default rate of a Guaranteed Student Loan Program. For example, in calculating the net default rate, the dollar amount of loans in litigation is subtracted from the dollar amount of defaulted loans; therefore, the net default rate does not express as defaults those uncollected loans that are in litigation. As of June 30, 1984, 150 CGSLP loans were in litigation. According to a federal official in the Guaranteed Student Loan Branch, all defaulted loans may not be collected through litigation; therefore, the default rate may be understated.

Since federal fiscal year 1981-82, the CGSLP's cumulative default rate has been increasing. However, an increasing cumulative default rate may be common to newer student loan programs such as the CGSLP. According to federal officials responsible for the Guaranteed Student Loan Program, the age of a student loan program is a major factor to consider when looking at the cumulative default rate. The cumulative default rate is partially a function of loan volume; as more loans mature, more loans are subject to default.

The CGSLP's cumulative default rate was 1.8 percent in federal fiscal year 1980-81, rising to 6 percent in federal fiscal year 1981-82, the first year in which a significant number of students began to repay their loans. In federal fiscal year 1982-83, the cumulative default rate rose to nearly 9.5 percent. As of June 30, 1984, the CGSLP's cumulative default rate had increased to 13.1 percent. Rising default rates for the CGSLP are shown in Table 1 on the next page.

TABLE 1

CUMULATIVE DEFAULT RATES FOR THE CALIFORNIA GUARANTEED STUDENT LOAN PROGRAM FEDERAL FISCAL YEARS 1980-81 TO 1983-84

Federal Fiscal Year	Cumulative Defaults	Cumulative Matured Loans	Cumulative Default Rate
1980-81	$684,000	$37,940,000	1.80%
1981-82	$9,488,000	$157,977,000	6.01%
1982-83	$72,013,000	$758,627,000	9.49%
1983-84*	$123,641,000	$945,882,000	13.10%

*Figures as of June 30, 1984.

The commission calculates a specific cumulative default rate for each educational segment or type of school that participates in the CGSLP. These specific rates show how each segment contributes to the CGSLP's cumulative default rate. For example, as of June 30, 1984, cumulative default rates ranged from 5.0 percent for hospital education programs and 6.1 percent for the University of California to 26.7 percent for private vocational schools. Although students attending vocational schools account for only 17.3 percent of the total dollar amount of matured loans, these students account for 35.3 percent of the CGSLP's total dollar amount of defaults. In contrast, students attending hospital education programs and the University of California account for a total of 12.6 percent of the CGSLP's total dollar amount of matured loans and only 6.0 percent of the CGSLP's total dollar amount of defaults. These data indicate that students with CGSLP loans

who attend vocational schools contribute more to the CGSLP's rising default rate than students with CGSLP loans who attend hospital education programs and the University of California combined. Table 2 on the next page presents cumulative default rates by educational segment.

TABLE 2

DEFAULT STATISTICS FOR EDUCATIONAL SEGMENTS OF THE CALIFORNIA GUARANTEED STUDENT LOAN PROGRAM JUNE 30, 1984

Segment	Defaulted Loans	Percent of Total Defaults	Matured Loans	Percent of Total Matured Loans	Cumulative Default Rate*
Vocational Schools	$ 43,731,000	35.3%	$164,064,000	17.3%	26.7%
Community Colleges	25,521,000	20.6	129,259,000	13.7	19.7%
Private 2 Year	3,096,000	2.5	23,014,000	2.4	13.5%
Out of Country	226,000	0.2	2,244,000	0.2	10.1%
Out of State	5,055,000	4.1	57,622,000	6.1	8.8%
State Universities	16,207,000	13.1	179,594,000	19.0	9.0%
Private 4 Year	22,467,000	18.2	269,956,000	28.6	8.3%
University of California	7,245,000	5.9	118,245,000	12.5	6.1%
Hospital Education Programs	93,000	0.1	1,884,000	0.1	5.0%
Total	$123,641,000	100.0%	$945,882,000	100.0%	13.1%

*These rates may be slightly overstated because they were obtained from the Electronic Data Systems Corporation's monthly report, which reflects outstanding rather than cumulative dollar amounts.

When the dollar amount of CGSLP defaults rises, as expressed by the cumulative default rate, the burden to the federal taxpayer increases. As costs for the Guaranteed Student Loan Program increase, the U.S. Department of Education requests more money in its budget for the coming fiscal year. Major federal costs for the Guaranteed Student Loan Program are interest payments to lenders, special allowance payments to lenders, and reinsurance costs paid to states as reimbursement for defaulted loans.

For federal fiscal year 1982-83, the federal government paid the California Student Aid Commission approximately $56.7 million in reimbursements for defaulted loans. Overall, the federal government spent $406 million to reimburse states for the purchase of defaulted loans during that year; this amount constitutes 14 percent of all program costs. For federal fiscal year 1983-84, the federal government estimates that reimbursement to states for the purchase of defaulted loans will increase to 18 percent of the total program costs of the Guaranteed Student Loan Program.

II

THE STUDENT AID COMMISSION'S LIABILITY FOR DEFAULTED LOANS

The "trigger reinsurance" rate determines the percentage of the dollar amount of defaulted student loans that the Student Aid Commission must pay and the percentage that the federal government will pay in a given federal fiscal year. As of May 31, 1984, the commission had paid approximately $1.7 million for the purchase of defaulted student loans because the trigger reinsurance rate exceeded the limits specified by the federal government. The commission paid this amount from the State Guaranteed Loan Reserve Fund (reserve fund). The reserve fund receives no support from the State's General Fund; it is composed of federal funds, investment earnings, and insurance premiums paid by students. The balance of that portion of the reserve fund specifically designated for the purchase of defaulted loans was approximately $43 million as of June 30, 1984. The commission projects that this balance will be $49.7 million at the end of federal fiscal year 1984-85.

As defined by federal regulations, the trigger reinsurance rate determines the percentage of the dollar amount of defaulted loans that the federal government will pay and the percentage that the commission must pay in a given federal fiscal year. The federal government sets the trigger reinsurance rate at zero at the beginning of each federal fiscal year. Throughout the fiscal year, the federal

government calculates the trigger reinsurance rate by dividing the dollar amount of claims for defaulted loans for which the federal government reimburses the commission by the dollar amount of the original principal of loans in repayment at the end of the previous federal fiscal year.

The trigger reinsurance rate increases as the dollar amount of defaulted loans increases, and the higher the trigger reinsurance rate, the greater the contribution the commission must make toward payment of defaulted loans. If the trigger reinsurance rate is 5 percent or less, the federal government reimburses the commission for 100 percent of the dollar amount of defaulted loans. If the trigger reinsurance rate exceeds 5 percent, the federal government reimburses the commission for 90 percent of the dollar amount of defaulted loans from the date that the rate exceeds 5 percent, and the commission pays for the remaining 10 percent. If the trigger reinsurance rate exceeds 9 percent, the federal government reimburses the commission for 80 percent of the dollar amount of defaulted loans from the date that the rate exceeds 9 percent, and the commission pays for the remaining 20 percent.

The federal government reimburses states for 100 percent of the defaulted loans during the first five federal fiscal years of a Guaranteed Student Loan Program. For the commission, this five-year period ended September 30, 1983. During the first five years of the California Guaranteed Student Loan Program, the federal government reimbursed the commission approximately $66 million for defaulted loans.

Beginning October 1, 1983, the commission became liable for a percentage of the dollar amount of defaulted student loans. In March 1984, the trigger reinsurance rate exceeded 5 percent, and the commission thus became responsible for paying 10 percent of the dollar amount of defaulted loans. The commission's payments for defaulted loans totaled approximately $1.7 million as of May 31, 1984. (Approximately $11,000 of this amount was for defaulted loans under the California Loans To Assist Students Program.) As of the same date, the federal government had paid approximately $47 million for claims for defaulted loans that the commission submitted during federal fiscal year 1983-84. (Approximately $198,000 of this amount was for defaulted loans under the California Loans To Assist Students Program.)

The commission will continue to be responsible for paying 10 percent of the dollar amount of defaulted loans during federal fiscal year 1983-84 unless the trigger reinsurance rate exceeds 9 percent. As of May 31, 1984, the trigger reinsurance rate was 7.5 percent. If this rate exceeds 9 percent, the commission will be responsible for paying 20 percent of the dollar amount of defaulted loans from that point until the end of the current federal fiscal year. The trigger reinsurance rate will exceed 9 percent if the dollar amount of claims for defaulted loans for which the federal government reimburses the commission exceeds $57.7 million during federal fiscal year 1983-84. As stated earlier, as of May 31, 1984, the federal government had already reimbursed the commission for approximately $47 million.

As of August 14, 1984, the commission had not yet been reimbursed for claims for defaulted loans that it submitted to the federal government in June. The commission expects that as of June 30, 1984, total reimbursements for federal fiscal year 1983-84 will be approximately $55.3 million, causing the trigger reinsurance rate to reach 8.6 percent. If the trigger reinsurance rate continues to increase as it has, this rate will exceed 9 percent before the end of the 1983-84 federal fiscal year.

The commission uses money only from the State Guaranteed Student Loan Reserve Fund (reserve fund) to purchase defaulted loans. This fund is composed of insurance premiums paid by students, federal administrative cost allowances, federal advances, investment earnings, and federal reimbursements for insurance claims paid to lenders. The reserve fund receives no support from the State's General Fund. The reserve fund has continued to grow since the inception of the CGSLP. For the last four state fiscal years, the reserve fund balances for that portion of the reserve fund that the commission specifically designated for the purchase of defaulted loans were as follows: $9.9 million on June 30, 1981; $22.8 million on June 30, 1982; $32.9 million on June 30, 1983; and approximately $43 million on June 30, 1984. These amounts do not include federal advances that could also be used to purchase defaulted loans. As of June 30, 1984, these advances totaled $9.1 million.

For the 1984-85 federal fiscal year, the commission projects that the trigger reinsurance rate will reach 8 percent in the fourth quarter, resulting in the commission's paying a total of $2.8 million from the reserve fund for the purchase of defaulted loans. Nevertheless, the commission projects that the reserve fund will still increase by $7.3 million during federal fiscal year 1984-85 because of investment earnings and insurance premiums that students will pay. This increase will result in a projected balance of $49.7 million that the commission specifically designates for the purchase of defaulted loans.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

Date: September 17, 1984

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STATE OF CALIFORNIA GEORGE DEUKMEJIAN, *Governor*

CALIFORNIA STUDENT AID COMMISSION
1410 FIFTH STREET
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September 11, 1984

Mr. Thomas W. Hayes
Auditor General
660 J Street
Suite 300
Sacramento, CA 95814

Dear Tom:

We have received and reviewed the draft report entitled "Defaulted Loans Under the California Guaranteed Student Loan Program."

We agree with the statements contained in the report. On that basis, we have no comments which we feel should be included in the final report when issued.

If further information is needed, please contact me.

Sincerely,

Arthur S. Marmaduke
Director

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps